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MANUFACTURERS HANOVER

Economic Report

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Commentary on Pertinent Economic Issues

The Disappearing Invisible Hand

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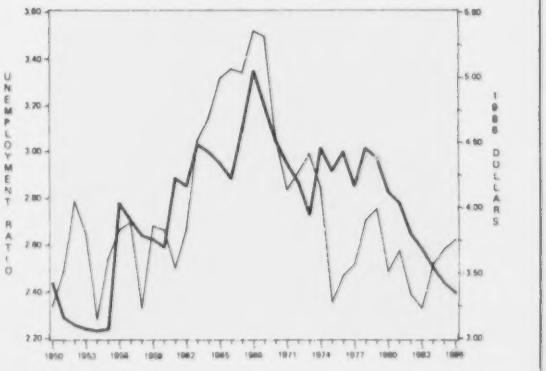
Americans seem to be increasingly dissatisfied with the workings of the marketplace. A spate of articles has recently appeared questioning the benefits of deregulation in a number of industries. In some cases, such as the nation's telephone system, deregulation has brought forth higher prices for many users, as well as a good deal of confusion when it comes to determining responsibility for repairs. In other cases, such as the airlines, prices have fallen–but so has service. And when it comes to dealing with such issues as the environment, the public, according to recent surveys, wants more–not less–government involvement.

This attitude has not gone unnoticed in Washington. For while the government has been deregulating with one hand, it has been interfering with the workings of the marketplace with the other. Remember the "voluntary" restraints on imports of Japanese cars? These came about early in the Reagan Administration as did similar efforts to slow down imports of steel from Brazil and textiles from the Far East. Not too long ago, the Administration got into a flap with our neighbor to the north which led to the President imposing tariffs on Canadian lumber. Washington has also threatened to impose tariffs on imports of food from the Common Market, and just recently, did levy a 100 percent tariff on certain microchips produced in Japan. The domestic front has not been left untouched, either, since Congressional Democrats have just proposed an increase in the minimum wage.

Before this goes any further, it might be helpful if readers remember what happens when markets are not allowed to clear. That is–what the consequences are of the government passing laws or taking such other actions as imposing import restraints that interfere with the normal process of supply and demand by sending out incorrect signals to the markets. Surpluses or shortages will arise, depending upon the relation of the price that the government seeks to establish compared with the price that would otherwise be set in the marketplace. And there will certainly be an effect on prices if the government acts to alter supply or demand.

CHART I
RATIO OF TEENAGE UNEMPLOYMENT RATE
TO TOTAL UNEMPLOYMENT RATE (THIN)
VS. REAL MINIMUM WAGE (THICK)



Price Floors . . .

Let's take the minimum wage, for starters. Chart I shows the marketplace in action. Washington may mandate increases in the minimum wage from time to time, but it cannot force employers to hire the people most likely to be affected by this–teenagers. The heavy line depicts the minimum wage adjusted for inflation. As you can see, it peaked in the late 1960s. It has fallen sharply since 1981 because the minimum wage has been unchanged over that time while consumer prices have advanced by more than 26 percent. This may seem inequitable until one examines the relative ability of teenagers to find jobs.

It was toughest for youngsters to find work in the late 1960s–just when the real minimum wage was at its highest. It is relatively easier today, as you can see from the decline in the thin line which compares the teenage unemployment rate with the total unemployment rate. One should compare the *ratio* of teenage unemployment with total unemployment, rather than looking at teenage unemployment in the absolute. This way, it is possible to transcend the business cycle. In other words–in 1968 the teenage unemployment rate was about 3½ times the total unemployment rate whereas today it is a little more than 2½ times. This appears to be largely because the minimum wage today is

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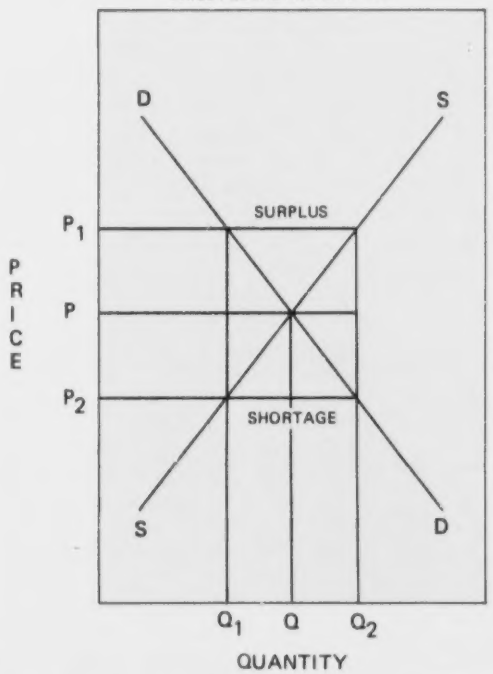
more palatable to employers relative to other costs of doing business than it was in the 1970s or in the 1960s.

Another way to look at this is through Chart II. Students of economics will recognize this as a traditional supply and demand chart with price on the vertical axis and quantity depicted horizontally. For a normal commodity, as prices go down more will be demanded, hence the downward sloping line of the demand curve from left to right, but less will be offered. As prices go up, less will be demanded and more will be offered, witness the upward slope of the supply curve from left to right. At price levels P and quantity levels Q the amount offered is equal to the amount demanded and the markets are said to clear.

CHART II
SUPPLY AND DEMAND:
PRICE FLOORS AND CEILINGS



If, however, the price were to rise to P_1 [an increase in the minimum wage], the number of job openings [Q_1] would fall short of the number of applicants [Q_2] and a surplus [a higher than average jobless rate] would result. This is because the minimum wage, most times, appears to have been higher than the wage employers would offer to entry-level people in the free market.

Those who advocate an increase in the minimum wage no doubt have the best of intentions. They seek to increase the income of those who are either paid the minimum wage or very close to it. However, and notwithstanding the fact that higher wage costs will lead employers to raise selling prices thereby producing more inflation, the initial effect of a rise in the minimum wage appears to be the creation of additional unemployment–especially among teenagers and other entry-level workers. It would be interesting to know how many of these people would prefer to be employed at $3.35 an hour rather than unemployed at the proposed minimum of $4.65 an hour.

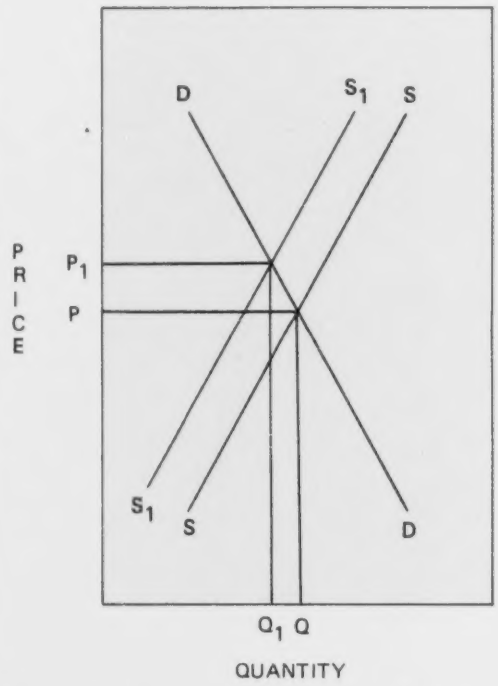
By the way, the same analysis holds true for the nation's farm problem. We have surpluses of farm commodities stacked up in storage bins because the government for years has been supporting prices above their market levels.

. . . And Price Ceilings . . .

Chart II also shows what can happen when the government interferes with the price mechanism in an effort to keep the price *below* the market price [represented by P_2]. In this instance, the quantity supplied shrinks from Q to Q_1 since it is less profitable to offer the item in question. On the other hand, the quantity demanded expands from Q to Q_2 as buyers perceive a bargain. In this case, the difference between the quantity supplied and the quantity demanded is a shortage. And lest you think this is only a classroom example with no application to the real world, I would remind you that the United States has experienced shortages many times in the past, most recently when the government levied controls on prices of petroleum products. Lines formed at gasoline stations in many parts of the country reflecting the inability of the markets to clear.

Have we learned from this experience? I am not sure. Interior Secretary Donald P. Hodel recently predicted that "people would be sitting in gas lines any time within the next two to five years". He must be planning to control oil prices, because that's the only way that this is going to happen. As long as the price mechanism is allowed to apportion supply and demand, there will be plenty of oil available at affordable prices. For if prices do rise, they will bring forth additional quantities of oil while at the same

CHART III
SUPPLY AND DEMAND:
QUOTAS



time cutting back demand in the form of conservation. If this sounds familiar, it is because this is exactly what has been happening since the first round of oil price increases nearly 14 years ago.

. . . Create Surpluses And Shortages . . .

Americans have already become more efficient users of oil. Automobiles are a good example. Fourteen years ago, the nation's automobile fleet averaged 13 miles per gallon; last year's fuel efficiency was 18.3 mpg. And since today's new cars average 42 percent better mileage than even this figure, you can be assured that motorists will be using even less gasoline over the coming years. For the economy as a whole, thanks to better home insulation and substantial capital investment by businesses in energy-saving structures and equipment, the relationship between energy use and economic growth has changed significantly over the past dozen years. During the half-century prior to the mid-1970s, each one percent rise in GNP output required a one percent increase in energy input. Since then that ratio has changed drastically: Each one percent rise in energy use now supports an eight percent rise in the real GNP!

. . . While Quotas Add To Inflation

Turning back to the international scene, Chart III shows the effects of one form of restraint of trade: Quotas. The chart is laid out the same way as Chart II. The main difference here is that, instead of acting on the price level, the government acts on the quantity available. The quantity supplied and demanded at market price P is Q. However, when the government limits the quantity of, for example, imported autos from Japan, it shows up as a change from Q to Q_1 on the horizontal scale and a shift in the corresponding supply curve from S to S_1. Assuming the same demand, you can see that the new supply curve intersects with demand at a higher price, P_1.

In other words—by restricting the supply of Japanese-made automobiles, the government has caused their price to go up. This is supported by a Brookings Institution study, which concluded that the "voluntary" quotas on Japanese cars caused their prices to go up by an average of $2,500. The Brookings study also said that, because of the umbrella provided by higher-priced Japanese imports, the price of an average American car went up by about $1,000 at the same time. Thus Americans are estimated to have paid an extra $26.6 billion in 1984 and 1985 as a result of these restraints. Furthermore, a study produced at Georgetown University concludes that protection from imports of all kinds cost U.S. consumers $65 billion in 1986!

With the dollar down substantially against such major currencies as the Japanese yen and German mark, you can see why inflation fears are once again permeating the financial markets. A lower dollar means higher prices for imported goods, which, in the past, has usually been followed by similar price increases posted by domestic manufacturers. The threat of more inflation has caused interest rates to rise and the stock market to fall. If these trends continue, our 4½-year economic expansion will be in jeopardy.

It is ironic, therefore, that an Administration which came in determined to lick inflation and revitalize the economy may well leave office doing just the opposite if it continues to interfere with the workings of the Invisible Hand. ■

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